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Turning Up the Heat: Staying Ahead of the SEC's New Accelerated Enforcement Strategy

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SEC Chairman Mary Schapiro's recent statements about the commission's plans for aggressive and accelerated investigations should serve as a warning for attentive companies that the usual rules of engagement have changed. Fast-tracked formalization of investigations, delegated penalty negotiation authority, and improved whistleblower complaint processing will place the unprepared company or individual at a critical disadvantage.

Since her swearing in as chairman on January 27, Schapiro has signaled a multi-faceted strategy to enforce what she calls the "New Era of Responsibility" in the financial markets. "Reforms can — and will — be imposed by the SEC," she told an assembly of chief compliance officers on March 10.

Carney is co-chair of the white collar defense and corporate investigations practice group at Baker and Hostetler in New York, and Cohen is an associate with the firm and administrator of its white collar group. Carney is also the former Chief of the Securities Fraud Unit at the U.S. Attorney's Office in New Jersey.

Compensating Whistleblowers

Beginning with the enhanced use of whistleblower complaints to initiate investigations, Shapiro has promised to "move very aggressively to improve staff's use of tips and complaints from investors and whistleblowers." Specifically, the commission has engaged an outside research center to improve the efficiency and effectiveness of how the SEC uses tips from whistleblowers — be they disgruntled employees, competitors or private fraud investigators — to identify leads for enforcement actions. Schapiro hopes to take this one step further. As she told a key Senate committee on March 26, "I expect to come to you in the near term with a request for authority to compensate whistleblowers who bring us well-documented evidence of fraudulent activity." In short, the commission wants to incentivize the population to come forth with tips, while increasing its ability to sort, analyze, and act on those tips.

Fast-Tracked Subpoenas and Penalties

Once a lead is identified, from a whistleblower or any other source, the commission's strategy grants greater freedom and authority to the

enforcement staff. Schapiro, a former SEC commissioner who understands the investigative process inside the agency, is reversing constraints formerly placed upon the staff, allowing them the freedom to take action against companies faster and with less control from above. The unleashing of the enforcement staff is two-fold: they have been given an accelerated ability to formalize investigations and thereby greater power to issue subpoenas for testimony and documents, and greater authority to negotiate cases that impose monetary penalties.

Regarding the increased subpoena power, Ms. Schapiro told the Practising Law Institute on February 6 that she intends to "provide for more rapid approval of formal orders of investigation — the permission slips given out by the commission that allow SEC staff to use the power of subpoenas to compel witness testimony and the production of documents." She got even more specific: "To ensure that subpoena power is available to SEC staff when needed, I've given direction for... timely approval of formal orders by seriatim approval or where appropriate, by a single commissioner acting as duty officer." These changes will increase the agility of the enforcers investigating a lead.

Regarding the power to of the staff to bring monetary cases, Ms. Schapiro said she is acting to end the commission's penalty pilot program, removing those approvals needed from the commission in cases involving monetary penalties for public companies in civil fraud actions. She intends to end the procedures which "introduced significant delays into the process of bringing a corporate penalty case; discouraged staff from arguing for a penalty in a case that might deserve a penalty; and sometimes resulted in reductions in the size of penalties imposed." The staff will face fewer administrative blockades, and will be able to effectively increase penalties against companies with less oversight.

A New Sheriff and More Cops on the Beat

The commission has also installed a former in-the-trenches federal prosecutor — Robert Khuzami — as the new Director of the Division of Enforcement. On May 7, during this testimony to the U.S. Senate Banking Committee, Khuzami outlined a plan to aggressively enhance enforcement efforts by

- increasing the number of SEC trial attorneys to present a 'credible threat' to defendants, improve the ability to win at trial and increase settlement outcomes;
- increasing paralegal and para-professional support, to free up enforcement attorneys to focus on investigative tasks;
- creating specialized groups of attorneys along product, market or transactional lines and increasing collaboration among staff across regions and;
- reconfiguring the management

structure of the division and reducing the levels of review and approvals required for investigative steps to be taken.

Khuzami's extensive securities and white collar prosecution experience as chief of the Securities and Commodities Fraud Unit in the U.S. Attorney's Office for the Southern District of New York will undoubtedly help the commission streamline the investigative coordination between the SEC and Department of Justice, allowing for increased collaboration on cases.

Shapiro's strategy also includes putting more investigators on staff to work the cases. The President's fiscal year 2010 budget request includes a 13 percent increase for the SEC over the fiscal year 2008 budget. The Senate is receptive to such a budget increase, specifically requesting Schapiro's view on the SEC's need for additional staffing and resources.

Creating a Firebreak

Paid whistleblowers, fast-tracked subpoena power, delegated penalty authority, and a veteran criminal prosecutor at the helm — what does all this mean? What it likely means is a marked increase in new investigations, increased use of the compulsory process, and more fines.

While the goal of every public company and individual is to avoid an SEC investigation in the first place, the realities of the current legal and economic environment make it likely that more and more companies and individuals will be faced with the prospect of dealing with the SEC as a witness or as a target. Accordingly, the primary objective for any public company or individual is to be ahead of the curve in

dealing with the SEC in a potential or actual investigation.

- Find problems now: No public company is immune from bad actors or regulatory mistakes. Institute measures to investigate problems on a real-time basis, while the ability to address them internally still exists.
- Tighten up compliance procedures initiate a review of all policies regarding financial reporting, securities compliance, and Sarbanes-Oxley.
- Pay special attention to whistleblower policies, to avoid turning a small inquiry into a retaliation investigation. If possible, engage counsel to design and test how well your procedures work.

Subpoenas and Fines

Historically, many weeks or months could pass from the initiation of an SEC inquiry to the issuance of an Order of Formal Investigation and the delegation of subpoena power. Now, it can be just days from the first phone call from the SEC staff to the first subpoena. Acting proactively to conduct an internal investigation into the suspected problematic behavior as soon as it is discovered allows the company to get its arms around the facts and to properly frame the issue. In addition, the rapid investigation and reporting of the conduct to the SEC will best position the company to argue for a reduced fine, or no fines at all.

The SEC may have turned up the heat, but with the use of solid compliance procedures and a proactive investigative strategy, this doesn't mean you have to get burned.■